

**BRIEF AND PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW  
AND COMMENTS AND EXCEPTIONS TO RECOMMENDED DECISION  
FILED ON BEHALF OF NORTHWEST DAIRY ASSOCIATION  
AND WESTFARM FOODS, INC.**

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**I. INTRODUCTION**

This Brief and Proposed Findings of Fact and Conclusions of Law and Comments and Exceptions to Recommended Decision are filed on behalf of Northwest Dairy Association (NDA), a cooperative association that markets the milk of producer members on the Pacific Northwest and Western Federal Milk Marketing Orders (Orders 124 and 135, respectively).

These comments are also filed on behalf of WestFarm Foods, which is a subsidiary of NDA and which operates a cheese and whey manufacturing plant at Sunnyside, Washington, a butter plant at Issaquah, Washington, and powder plants at Caldwell, Idaho, Chehalis, Washington, and Lynden, Washington. Most of the milk processed at these plants is classified and priced as Class III or Class IV under a Federal Milk Marketing Order issued by USDA and published at 7 C.F.R. Part 1000 *et. seq.* NDA and WestFarm Foods (collectively "NDA" for this Brief), therefore, are vitally interested in the outcome of this proceeding and greatly appreciate this opportunity to file this Brief and these Comments and Exceptions to the Recommended Decision.

*Background of Administrative Proceedings*

This extended administrative rule making proceeding primarily involves the formulas by which Federal Milk Marketing Orders determine the prices paid for milk used to manufacture cheese and whey (Class III) and to manufacture butter and powder (Class IV). While the record evidence was submitted at a formal rule making hearing held in May of 2000, the history of this particular matter now before USDA extends back to at least 1996, and also to the creation of the

Class III-A price for milk established for Federal Milk Marketing Orders in a 1991-1993 proceeding.<sup>1</sup>

When in 1993, the Secretary undertook the establishment of classified milk prices for non-fat dry milk (manufactured milk products) through formula pricing, the Secretary undertook then and for the future an obligation to set such rates through rate making as constrained by constitutional law (e.g. full consideration of all cost factors). Proponents argued, and the Secretary found, "that the market values for NFDM are not appropriately reflected by the M-W price [then used to establish the Class III price] at all times." 56 Fed. Reg. at 65803 (December 19, 1991). Having reached this conclusion, the Secretary then undertook to establish a regulated price that included a return on equity, maintained financial integrity and assured the ability to attract new capital, pegging Class III-A prices to proceeds from sale at market values. In the informal rulemaking that followed enactment of the Federal Agriculture Improvement Act of 1996 ("1996 Farm Bill"), the Secretary then expanded this established practice of adopting formula prices based upon regulated break-even prices by considering and adopting end-product formula prices for both Class III and Class IV in the Final Rule announced for Federal Order Reform.

However, after the first round of litigation (in 1999) and further Congressional intervention requiring a hearing on these formulas, USDA has now for the second time announced unacceptable proposals for pricing Class III and Class IV, unlawfully departing from its prior decisions and inexplicably overlooking significant contrary record evidence. In short,

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<sup>1</sup> Federal Order history of end-product pricing in fact predates the introduction of Class III-A in the early 1990s. Both the Oregon Washington Order and the Puget Sound Orders, predecessors to the Pacific Northwest Order, and also the merged Pacific Northwest Order contained "price snubber" provisions that were used to adjust the basic formula price based upon product prices, yield factors and processing costs. 7 C.F.R. §§ 1124.19,

the Class III and Class IV pricing formulas recommended by the Administrator would be illegal, if adopted, because:

- (1) the proposals depart from prior decisions and reasoned analysis without explaining and justifying this departure;
- (2) the proposals were made after Court intervention barring consideration of a separate value for butterfat calculated in the two formulas and without further record evidence having been taken, but resulting in even greater price impacts on manufacturers of Class III and Class IV products;
- (3) the proposals fail to consider several relevant factors supported by the record and reach conclusions unsupported by the record;
- (4) the proposals fail to meet the constitutional standards for rate making now undertaken by the Secretary for all Class III and Class IV products; and
- (5) the proposals create as to NDA a trade barrier for sales of its manufactured products that is illegal under 7 U.S.C. § 608c(5)(G).

## **II. BRIEF AND CONCLUSIONS OF LAW REGARDING LEGAL STANDARDS NOT MET BY RECOMMENDED DECISION**

A. The Associate Administrator of the Agriculture Marketing Service has acted arbitrarily and capriciously, in that the Recommended Decision fails to follow prior Department decisions and fails to provide a sufficient level of explanation for departure from prior decisions.

The Associate Administrator of the Agriculture Marketing Service (hereafter “Administrator”) is simply not writing on a blank slate with respect to the issues before him in this proceeding. This existing record of decisions is a critical factor that requires any Administrator to explain fully "and supply a reasoned analysis" for any and all changes in policy and deviations for his past decisions. *Motor Veh. Mfrs. Ass'n v. State Farm Mut. Automobile Ins. Co.*, 463 U.S. 29 (1983). In *Motor Vehicle Mfrs.*, the U.S. Supreme Court expressly rejected the National Highway Traffic Safety Association's decision to revoke its earlier imposed

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1124.51a, 1125.19 and 1125.51a (1988) and (1989). The existence and significance of these pre-order reform formulas and their rationales as applied in western orders cannot be ignored by the Department in this rule making.

requirement that new motor vehicles produced after September, 1982 be equipped with passive restraint systems. In holding that the Agency had acted arbitrarily and capriciously, the Court expressly held:

an agency changing its course by rescinding a rule is obligated to supply a reasoned analysis for the change beyond that which may be required when an agency does not act in the first instance.

*Id.* at 42.

This standard of arbitrary and capricious is narrow, but it absolutely requires the Administrator to examine all of the relevant data and articulate a satisfactory explanation for his action including a "rational connection between the facts found and the choice made." *Id.* at 44 quoting with approval *Burlington Truck Lines, Inc. v. U.S.*, 371 U.S. 156 (1962).

As is explained fully below in the Comments and Exceptions portion of this filing, the Administrator has failed repeatedly to meet this standard. Nor can he do so, because a rational basis does not exist -- as demonstrated herein, and by a number of the other Comments filed in this proceeding by other manufacturers of cheese or the International Dairy Foods Association. For instance, beginning in 1993 when the Secretary adopted Class III-A in its Final Decision and as recently as the Final Rule issued in the process known as Federal Order Reform, the Department has repeatedly discussed and recognized the impact that California's separate system for raw milk price regulation has on the Federal Milk Order System. After much and long debate, the Secretary determined in 1993 to use the Western States Powder price in the Class III-A formula for three orders (124, 131 and 135) all of which border California, while using a different price series for the rest of the orders. The Department's reasoning, upheld in court, inextricably tied this pricing of nonfat dry milk formula to California:

Handlers who produce NFDM under these three Federal orders have been particularly influenced by the Western NFDM price

because of their close proximity to California processors who account for a large portion of the nation's powder and whose milk used for such manufacturing has been priced on the basis of a product price formula under the State program.

58 Fed. Reg. 58112 at 58125 (October 29, 1993). The record evidence in this proceeding establishes that both the NFDM and cheese manufacturers "in close proximity to California processors" are still "particularly influenced" by product price formulas under the (California) State program. The facts have not changed, but the Secretary suddenly finds it unnecessary to account for that close proximity and influence. The issue of price alignment with nation's largest dairy producing state is simply ignored in the Recommended Decision.

In the Final Rule of Federal Order Reform, the Department acknowledged again the importance of California regarding Class III and Class IV price formulas. After comparing the proposed Class III price and the Class IV portion of the then Basic Formula Price to the then current Class III price and before making the "important" comparison of the relationship in price movements between the proposed Class III and Class IV price and the then current basic formula price, the Department made a telling comparison of the proposed Class III price and the California Class 4b price as well as the proposed Class IV price and the California 4a price. In 41 lines of text in the Final Rule, the Secretary made a comparison of the then current prices, the proposed prices and the California prices, in order to establish close alignment with the California system. 64 Fed. Reg. 16026 at 16100-101 (April 2, 1999). And of course, this was a necessary analysis because as the Department noted at the beginning of the comparison section that the requirements of a basic formula price are "based on the assumption that the **national supply and demand** for manufacturing milk as reflected in the current BFP is in relatively good balance." *Id.* at 16100. The national dairy economy can not be analyzed if the nation's largest dairy producing state – California – is ignored.

As a result of 3 years of informal rulemaking and overwhelming industry and expert input, this section of the Final Rule concluded the following about the actual formulas established by the Department:

The Class III and Class IV prices **clearly reflect** the value of milk used in the respective manufactured products, whereas the current basic formula price reflects primarily the value of milk used to manufacture cheese in a particular region of the U.S. (Minnesota and Wisconsin).

*Id.* at 16101. Congress required that the Secretary take another look at the Class III and IV formulas in the current proceeding. In the Recommended Decision, without consideration of the impact of the California system, the Department has now concluded that the Final Rule's Class III and Class IV prices did not clearly reflect the value of milk used in the respective manufacturing products. Nonetheless, even the Department, in the hearing notice (Exhibit 1) which led to this Recommended Decision, noted that “prices paid for manufactured milk under federal orders cannot get too far out of alignment with the value of milk for manufacturing in the rest of the United States.” A similar observation appears on page 3 of the “Economic Analysis of the Recommended Decision”, published simultaneously with the Recommended Decision. Given these repeated statements about the need for price alignment, it is shocking that nowhere in the Recommended Decision or in the Economic Analysis is there any reference at all to how prices generated by the new Class III and IV formulas would align with the corresponding prices in California (or in any other region of the country that lies outside Federal order regulation).

The question that now begs answering even without *Motor Veh. Mfrs* is what rationale does the Administrator have for abandoning both the California alignment analysis and the conclusion in the Final Rule that the now-rejected price formulas clearly reflected manufacturing values? There is no rationale for these two departures from prior decisions in the Recommended

Decision precisely because none exists. California's pricing system was and remains an extremely significant, if not overwhelming, factor to consider when establishing **national** manufacturing values.

Moreover, an abrupt change in policy is no different than a repeal of existing policy under *Motor Veh. Mfrs.*:

A volte face . . . may be an attempt to avoid the notice and opportunity for comment that the Administrative Procedure Act requires for alteration of a rule. When an agency gets to the Dictionary of Newspeak and pronounces that for purposes of its regulation War is Peace, it has made a substantive change for which the APA may require procedures. If in the airbags case, *Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Insurance Co.*, 463 U.S. 29 (1983), instead of repealing the rule, the agency had proclaimed that an ordinary seat belt is a "passive restraint", the Court would have treated this the same as it treated revocation of the rule. Both require notice, an opportunity for comment, and an adequate record.

*Homemakers North Shore, Inc. v. Bowen*, 832 F.2d 408, 412 (7th Cir. 1987).

The Recommended Decision's proposal to adopt modified formulas inconsistent with past decisions is a "substantive change" necessitating full compliance with the procedural safeguards of the APA. It was precisely this kind of abrupt and unexplained departure from previous policies that *Motor Veh. Mfrs.* deplors. The Recommended Decision is arbitrary and capricious on its face in light of at least 10 years of contrary decisions published, litigated and enforced.

B. The Recommended Decision does not provide sufficient justification for the pricing results obtained after remand of the Decision to the Secretary for having violated the APA.

Again the Administrator is also not writing on a blank slate with respect to substantive evidence and the appropriate level of judicial scrutiny that will no doubt follow this decision. With all due respect, NDA (and we suspect others) find it unduly coincidental at best that having

been enjoined from establishing a separate butterfat value for Class III from Class IV that was price enhancing as to Class III, the Department has found another circuitous route (and, as discussed above, an unexplained deviation) that just happens to result in an overall price level even higher than that complained of in the litigation filed before Judge Lamberth. It was this kind of results-oriented decision making by the Department in late 1991 that gave rise to multiple court fights and additional rule making proceedings in the Class III-A policy development. Ruling on a narrow issue in that litigation, both Judge Simpson of the Western District of Kentucky and Judge Wiseman of the Middle District of Tennessee held that such results-oriented policy making was quite simply "arbitrary and capricious". See *Memorandum Opinion and Order, Dairymen, Inc. v. Madigan* (August 4, 1992, Judge Simpson) at page 32. It is no less so today. Ultimately the Department's Class III-A decision was upheld, in no small measure because (ironically) the Department was found to have appropriately accounted for the impact of the California system. California's impact is also no less important today.

In addition to the requirements imposed by *Motor Veh. Mfrs.*, as a result of years of rule making and litigation, the Department's decisions in these matters are now, for better or worse, subject to a greater degree of scrutiny than under the less exacting rational basis test. This more exacting scrutiny results from the perception that after remand for procedural errors or insufficient evidence, an agency may well be so wedded to its prior conclusions or results that it fails to engage in any genuine reconsideration of the issues. In *Food Marketing Institute et al. v. ICC et al.*, 587 F.2d 1285 (D.C. Cir. 1978), the Court of Appeals for the D.C. Circuit applied this proposition in an FMI challenge to an informal rulemaking decision (the Second Agency Decision) that took place after an earlier informal rulemaking decision (the First Agency Decision), which was remanded by the Court of Appeals. After explaining that the standard of

review is whether there was a “rational basis” the Court nonetheless concluded that there was justification for a higher degree of scrutiny stating:

However, because of the posture of this case, a somewhat greater degree of scrutiny than might otherwise be appropriate is in order. . . . [T]he order under review here comes to precisely the same conclusion as the order previously remanded by this court. To be sure, where, as here, the remand merely requires the agency further to elaborate its reasoning, there is no requirement that the agency arrive at a different substantive result upon reconsideration. *At the same time, we must recognize the danger that an agency, having reached a particular result, may become so committed to that result as to resist engaging in any genuine reconsideration of the issues. The agency's action on remand must be more than a barren exercise of supplying reasons to support a pre-ordained result.* Post-hoc rationalizations by the agency on remand are no more permissible than are such arguments when raised by appellate counsel during judicial review.

*Id.* at 1289-90 (*emphasis added*). The Department here has accomplished the price enhancement that it sought all along, and was enjoined from establishing in the Tentative Final Decision dated (November 29, 2001), by shifting the value from the butterfat to the solids side (the only difference now being that the resulting higher prices are exacerbated). It may be, however unintentionally, that the Department may be reacting negatively to the industry's repeated and extended bouts of litigation over these issues. Regardless, the parties are entitled to a full and rational explanation of how the Department got from point A to point Z. It simply is not clear from the Recommended Decision and indeed, as will be discussed at some length below, the Department has inexplicably ignored numerous and significant record evidence to the contrary.

Since the *FMI* case, the D.C. Circuit Court of Appeals has on more than one occasion expressly invoked this higher degree of scrutiny. In *Greyhound Corporation v. ICC et al.*, the reviewing Court of an informal rulemaking decision confirmed that it would "accord a somewhat greater degree of scrutiny to an order that arrives at substantially the same conclusion as an order

previously remanded by the same court.” 668 F. 2d 1354, 1358 (D.C. Cir. 1981). In *Greyhound* the first agency decision was remanded with directions to rectify or explain the decision to regulate the securities of Greyhound even though Greyhound did not derive more than 50% of its gross income from transportation or related activities. 668 F.2d at 1357. The decision was a departure from the previously enforced rule that did not permit ICC regulation of a holding company’s securities unless it derived more than 50% of its gross income from transportation or related activities. This then is an extension of the *Motor Veh. Mfrs.* doctrine of a greater degree of scrutiny to cases such as this one in which the Department has already been subject to Court review. More recently in *Competitive Enterprise Institute et al. v. National Highway Traffic Safety Administration*, 45 F.3d 481, 484 (D.C. Cir. 1995), the Court again acknowledged this higher degree of scrutiny in matters such as this one.

NDA urges the Secretary to reconsider the Recommended Decision in light of the full and complete record (discussed at length in the Exceptions below and by other Class III and Class IV manufacturer Exceptors) and in light of the standards enunciated in both *Motor Veh. Mfrs.* and *FMI*.

C. The Administrator's Decision is Incompatible with the Requirements of the APA.

Despite an informal rule making lasting 3 years, multiple lawsuits, a court remand on the butterfat issue, Congressional intervention, testimony at 5 days of hearing regarding the proper formulas for Class III and Class IV, and the fact that a central focus of much of these rule makings has been the correct formulas used in the formulas for establishing Class III and Class IV prices, the Administrator blithely dismisses arguments on the formula issues made by a substantial and wide ranging portion of the industry, including both dairy farmer representatives and proprietary handlers. The Administrator summarizes the industry opposition on the Class III

and Class IV price formula issues at 66 Fed. Reg. 54072-75, and then "discharges" the obligation as to Class III and Class IV (including the *Motor Veh. Mfrs.* and *FMI* obligations) concerning these crucial issues in less than one full page each at 66 Fed Reg 54081-82 and 54077-78, respectively, all of which is non-responsive to the claims raised by those who support different formulas. Moreover, the Administrator's response to the numerous briefs filed in support of alternative formulas can only be charitably described as conclusory, especially because he never bothered to acknowledge, much less analyze the California issue.

The obvious, unanswered question is **how** do the pricing formulas adopted accomplish the pricing goal, especially in light of the Department's prior decisions? Without any effort given to discuss, analyze or to refute the calculations of opponents, the Department cannot carry even the lowest burden in rule making - to rationally and completely explain its decision, much less the burdens associated with *Motor Veh. Mfrs.* and *FMI*, discussed above. In fact, the very avoidance of a full discussion of all of these alternative calculations and the failure to address the concerns of Class III and Class IV manufacturers in any meaningful way merely serves to fuel fires of suspicion that the Department has lost its way in this thorny thicket. And that is of tremendous concern to NDA, because if that is the case, then "end-product pricing" doesn't work, and milk marketing orders can not survive.

The Exceptions discussed below and filed by other manufacturers of Class III and Class IV products identify numerous problems with the proposed formulas and provide detailed alternative formulas based upon record evidence and reasoned analysis. NDA respectfully demands that the Administrator rectify the serious deficiencies in the Recommended Decision -- by acknowledging the arguments, formulas and record evidence and either accepting the arguments and formulas discussed herein and in previous rounds of briefs concerning the

formulas or (unlikely as NDA believes) refuting them with a complete analysis and explanation for departure from prior decisions including the Class III-A decision in 1993 and the Final Rule of 1999.

Without undercutting or waiving its right to benefit from the degree of scrutiny that is appropriate under *Motor Veh. Mfrs.* and *FMI*, NDA urges the Administrator to also reconsider his obligations under the APA more generally. Section 556(d) of the APA provides that "[a] sanction may not be imposed or rule or order issued except on consideration of the whole record or those parts thereof cited by a party and supported by and in accordance with the reliable, probative, and substantial evidence. . . ." This language makes it clear, and numerous courts have uniformly held, that "an agency has a duty to consider all the evidence, **and to explain its decision fully.**" *Lorion v. United States Nuclear Regulatory Comm'n*, 785 F.2d 1038, 1042 (D.C. Cir. 1986) (emphasis added) (citing *City of Charlottesville v. Federal Energy Regulatory Comm'n*, 661 F.2d 945, 950 (D.C. Cir. 1981)).

Section 556 was adopted precisely to ensure the appropriate consideration of competing views; it requires that an agency decision such as the Recommended Decision be supported by substantial evidence. Substantial evidence is "such relevant evidence as a reasonable mind might accept as adequate to support a conclusion." *Universal Camera Corp. v. NLRB*, 340 U.S. 474, 477 (1951). To satisfy the "substantial evidence" test, the proposed regulation must be supported "by evidence on the record **considered as a whole.**" *Id.* at 185-488 (emphasis added) (holding that a court is precluded from sustaining an order merely on the basis of favorable evidence without taking into consideration all available evidence including contradictory evidence).

Further, the regulation must be based "on the full administrative record that was before the Secretary at the time he made his decision." *Citizens to Preserve Overton Park, Inc. v. Volpe*,

401 U.S. 401, 420 (1971) (holding that judicial review of agency's decision based on litigation affidavits and nothing else was inadequate); *see also Walter O. Boswell Memorial Hospital v. Heckler*, 749 F.2d 788 (D.C. Cir. 1984) (action was remanded because parties failed to provide the "whole record" to the Court).

Since courts must consider the entire record when reviewing an agency action, the Administrator too must consider all of the record before he makes a decision. 5 U.S.C. § 556(d) (a rule or order may not be issued "except on consideration of the whole record. . ."). However, the failure to discuss and address the points made in NDA's testimony and brief concerning the impact of California (among other Class III and Class IV manufacturers who favored different formulas) is a manifest failure to consider the entire record. It is as if NDA had never appeared.

In a recent case involving quasi-legislative action in a notice and comment setting, the D.C. Circuit ruled that an agency's failure to abide by the **procedural** requirements of the APA was grounds for permanently enjoining an agency's directives. *National Family Planning and Reproductive Health Ass'n v. Sullivan*, 979 F.2d 227 (D.C. Cir. 1992) (enjoining HHS' amendment to the prohibition of abortion counseling in Title X programs ("gag rule"), because the agency failed to take notice and comments as required by Section 553 of the APA).

Although this matter is a formal rule making (following notice and comment as a result of the 1996 Farm Bill), the holding in *National Family Planning* is equally applicable since the Department has obviously failed to analyze the impact of the proposed Class III and Class IV formulas in anything but a conclusory fashion, and, in particular, has ignored the impact of California. In fact, adherence to the requirements of the APA is more important in a formal rulemaking proceeding, where by statute a hearing is required rather than mere notice and comment. The APA provides procedural guidelines and protections for administrative decisions

based upon formal rule making precisely because such protections are "needed both for the protection of affected parties and to help achieve rational decisionmaking." *Marathon Oil v. EPA*, 564 F.2d 1253,1261 (9th Cir. 1977). The procedural requirements of the APA are heightened for these decisions (including the Recommended Decision) because they "have immediate nationwide application and, until amended by further rulemaking, would have to be applied to all subsequent applications." *Association of Data Processing v. Board of Governors*, 745 F.2d 677, 685 (D.C. Cir. 1984).

It is simply not enough for the Administrator to perform calculations, attach a model (not part of the record) and pronounce his view to be the answer. What happened to all of the formulas and evidence submitted by NDA and other Class III and Class IV manufacturers? The Administrator's failure to "examine the relevant data and articulate a satisfactory explanation for his action including a . . . connection between the facts found and the choice made" renders that decision arbitrary and capricious and, therefore invalid. *American Telephone and Telegraph Co. v. FCC*, 974 F.2d 1351 (D.C. Cir. 1992) (vacating an FCC order as arbitrary and capricious because the Commission failed to provide an adequate explanation for its refusal to consider a particular rate factor in changing its policy).

D. The Department's Class III and Class IV pricing formulas fail to account for all factors in rate making as required by case law and the U.S. Constitution.

As noted immediately above in the AT&T case, an agency must consider or provide an adequate explanation for its failure to consider a particular rate factor in changing its policy. In adopting Class III and Class IV formula prices (as opposed to non-regulated competitive proxies such as the old BFP or M-W formulas), the Department has embarked, for better or worse, on a course of rate making that is thus subject to existing precedents concerning how such rate

making shall proceed and the limits and requirements of such rate making. In fact end-product pricing formulas are subject to the U.S. Constitution's Fifth Amendment prohibition on taking property without just compensation. *See e.g., FPC v. Natural Gas Pipeline Corporation*, 315 U.S. 575, 600 (1942) (JJ. Black, Douglas, Murphy, Frankfurter Concurring, stating that “[r]ate making is a species of price fixing.”)

In the context of rate-making cases, the general rule that “the Constitution protects [business subject to government regulation through rate-making] from being limited to a charge for their property serving the public which is so ‘unjust’ as to be confiscatory,” was established in the late 1800s and early 1900s. *Covington & Lexington Turnpike Road Co. v. Sandford*, 164 U.S. 578, 597 (1896) (A rate is too low if it is “so unjust as to destroy the value of [the] property for all the purposes for which it was acquired,” and in so doing “practically deprive[s] the owner of property without due process of law”); *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 585 (1942) (“By long standing usage in the field of rate regulation, the ‘lowest reasonable rate’ is one which is not confiscatory in the constitutional sense”).

As it is now involved in rate making, the Department must not set minimum prices at a level that is confiscatory vis-a-vis processors. This means that processors cannot be forced to pay such high prices for milk as to result in their receiving too low a rate of return – they must be permitted to maintain business integrity, earn a rate of return commensurate with the industry risk, and attract capital. *Federal Power Commission v. Hope Natural Gas*, 320 U.S. 591, 602 (1944). As has been noted by another government agency (the Federal Maritime Agency):

Two landmark cases [including *Hope* as well as a 1923 case] established that investors in companies subject to rate regulation must be allowed an opportunity to earn returns sufficient to attract capital comparable to investments in other firms having the same amount of risk, and that revenues must not only cover operating expenses, but capital costs as well. The economic rationale for

setting the allowable rate of return of a regulated company equal to its cost of capital is that in the long run the regulated firm's customers will pay the lowest cost for service while at the same time the company's earnings will be sufficient to attract capital so that the company is able to provide the customers' desired level of service.

60 Fed. Reg. 46047 at 46049 (Sept. 5, 1995).

Moreover, the U.S. Supreme Court in 1989 affirmed and further explained its decision in *Hope in Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1989):

In *Hope* we ruled that historical cost was a valid basis on which to calculate utility compensation. 320 U.S., at 605 ("Rates which enable [a] company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risk assumed certainly cannot be condemned as invalid, even though they might produce only a meager return on the so called 'fair value' rate base."). We also acknowledged in that case that all of the subsidiary aspects of valuation for ratemaking purposes could not properly be characterized as having a constitutional dimension, despite the fact that they might affect property rights to some degree. **Today we reaffirm these teachings of *Hope Natural Gas*: '[I]t is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unreasonable, judicial inquiry...is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.'** [citation omitted] This language, of course, does not dispense with all of **the constitutional difficulties when a utility raises a claim that the rate which it is permitted to charge is so low as to be confiscatory: whether a particular rate is 'unjust' or 'unreasonable' will depend to some extent on what is a fair rate of return given the risks under a particular ratesetting system, and on the amount of capital upon which the investors are entitled to earn that return.** At the margins, these questions have constitutional overtones.

*Id.* at 310 (*emphasis added*). *Duquesne* remains good law. "It is not the theory, but the impact which counts," and that is why NDA feels so strongly about the obligation of the Department to consider the mind-boggling competitive advantage that the Recommended Decision would create

for California manufacturing plants, and not simply ignore that problem as was done in the Recommended Decision.

When combined with the Supreme Court's affirmance of the *Hope* case, the language from *Hope* cited above establishes that constitutionally reasonable rates must satisfy the following criteria: (1) provide a return to the equity owner that is commensurate with returns on investments of other enterprises having corresponding risks; (2) maintain the financial integrity of the enterprise; and (3) enable the enterprise to attract new capital. *Duquesne*, 488 U.S. at 310.

A principal component of rate making is consideration of all factors and, in the event a factor is rejected, an adequate explanation for the refusal to consider a particular factor. *Id.* As these Exceptions and others filed by manufacturers of Class III and Class IV products amply demonstrate, the Recommended Decision utterly fails to consider all factors or to explain how or why certain factors were discarded. These infirmities are not merely technical or obscure. They are basic and fundamental. Accurate make allowances, yield factors and other formula components are mandatory if the Department is to achieve its stated goal of a regulated price designed to emulate the competitive price series replaced and designed as a regulatory break even price including a return on equity, maintaining financial integrity and assuring the ability to attract new capital. The Recommended Decision simply fails to meet the stated goal even at the most basic levels. This failure renders the Recommended Decision arbitrary and capricious. It cannot stand.

E. The Recommended Decision as to NDA would create illegal trade barriers barred by 7 U.S.C. § 608c(5)(G).

As discussed at greater length below in the Exceptions, the Recommended Decision develops a methodology that assumes that all cheese plants do or should receive a national

average price, making no inquiry concerning the negative impacts this inference (which is contrary to the record evidence) has on plants in the West. This again is a departure from Department policy enunciated in 1993 regarding NFDM and Class III-A. Moreover, it also ignores the need for price alignment with California. These cost differences are significant enough to rise to the level of an illegal trade barrier should the Recommended Decision not be modified as discussed in these Exceptions.

Section 8c(5)(G) of the Agricultural Marketing Agreements Act, 7 U.S.C. § 608c(5)(G) provides:

No marketing. . . order applicable to milk and its products in any marketing area shall prohibit **or in any manner limit, in the case of the products of milk**, the marketing in that area of any milk or product thereof produced in any production area of the United States.

*(emphasis added)*.

In the leading case regarding illegal trade barriers in the dairy industry, *Lehigh Valley Coop v. United States*, 370 U.S. 76 (1961), the Supreme Court held that a compensatory payment provision of the New York-New Jersey Milk Marketing Order was invalid because it created an insuperable "trade barrier" to the sale of Pennsylvania produced fluid milk in the New York-New Jersey marketing area in violation of § 8c(5)(G) of the Act. 370 U.S. at 97-99. In the course of its decision the Court reviewed and explained in painstaking detail the background, legislative history and meaning of the statutory language that reads: "in any manner limit, in the case of the products of milk . . . the marketing of any milk . . . product produced in any production area of the United States."

As the Court explained, the section was adopted "to limit the Secretary's powers so as to prevent him from establishing 'trade barriers' [because] Midwestern legislators were particularly

concerned over this possibility. . . ." *Id.* at 92. The particular concern of the Minnesota and Wisconsin representatives was the possibility that the Secretary's milk orders would impede the marketing of Midwestern butter, cheese and similar storable dairy products into other marketing areas. *Id.* at 93-95. Section 8c(5)(G) emerged from the Conference Committee in its present form with the explanation that the section "denies the authority to limit **in any manner** the marketing in any area of milk products (butter, cheese . . . etc.) produced anywhere in the United States. . . ." *Id.* at 95 (quoting H.R. Rep. No. 1757, 74th Cong., 1st Sess. 21) (*emphasis supplied*).

While the Secretary may "limit" the inter-market sale of fluid milk to the extent of "attempt[ing] to put outside milk on an equal [price] footing with pool milk (370 U.S. at 97), **in the case of milk products**, such as cheese, butter and NFDM, the Secretary is simply prohibited from adopting **any** pricing provisions or price structure in the Federal Order System that would impede "in any manner" the marketing of milk products produced in one area of the United States into another area of the country. However, that is exactly what the Recommended Decision would do.

As discussed below, NDA would face economic trade barriers for the sale of its products in interstate commerce and into other areas covered by Federal Milk Orders, for two reasons. First, the Recommended Decision would require milk manufacturers who operate in Federal orders to pay substantially higher prices for raw milk than are paid in California, thereby effectively limiting the ability of Federal order plants to market into California. Second, the Recommended Decision assumes national cheese, butter and powder prices and assumes an average transportation cost, ignoring the reality of the record evidence and the Cornell model or location values, which is reproduced in part in Exhibit 54-4. Such a price disparity created solely by the Secretary's price formulas for Class III and Class IV would put NDA, and others similarly

situated, on an unequal competitive footing in the sale of cheese, butter and NFDM and clearly "limits" their marketing ability in plain violation of the "trade barrier" provision.

### **III. PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW**

Pursuant to 5 U.S.C. § 557(c), NDA and WestFarm Foods request the Secretary make the following Findings of Fact and Conclusions of Law:

#### **A. Class III Formula.**

1. *The Proposed changes to formulas are not "minimal" and are a shift of the economic burden from the discontinued separate butterfat price to the solids price.*

As explained herein, NDA takes exception to the revisions proposed in the Class III formula. NDA particularly objects to the erroneous conclusion reached by the Secretary and the Department (regarding the adjustments to the make allowances) that "Most of the adjustments are minimal" (66 Fed. Reg. at 54065). The quoted statement is defensible as to the explicit make allowances in the formulas, but there is also an implicit make allowance (gross margin) that is far more important, and the change in which is simply not "minimal". The implicit make allowance (which the Recommended Decision discusses as a "gross margin" (66 Fed. Reg. 54064 at 54087 (Oct. 25, 2001)) is the difference between the finished product value and the raw milk values (the Class prices).

This difference reflects the explicit make allowance and all other factors in the Class pricing formulas that raise or lower the class price. It is the total "economic room" a plant is given by the Class pricing formula to operate within; and for that reason, it is the very thing that will directly impact the financial viability of regulated plants. *See e.g.*, NDA testimony, Tr. 1791. The Department acknowledges that this gross margin would drop 16% (\$0.48 reduction from \$3.00 to \$2.52) comparing actual Federal Order prices with proposed prices for a 19-

month period. 66 Fed. Reg. at 54087. That is hardly a “minimal” change. And as is discussed below, the overall impact on the effective make allowance is far greater than this loss of 16% in the calculated gross margin.

It is absurd for the Department to suggest that a plant’s gross margin, even as calculated by the Department, can fall by over 16% and not have an impact on its ability to operate. The Department references the make allowances resulting from data in the CDFA and RCBS surveys. For the reasons IDFA identified at the hearing, these numbers are suspect, and in any event, they are based on average plant costs. The Department makes no provisions for the one-half of cheese production from plants whose costs are higher than this average, and would suffer severe strain from such a drastic decrease in their gross margins (even assuming that the Department had calculated accurately average gross margins). The Department blithely states that “the lower gross margins under the recommended formulas could lead to reduced over-order premiums to reflect increased milk costs and maintain current gross margins.” Nowhere does the Department cite testimony that shows that over-order premiums of this magnitude are common throughout the regulated by Federal Milk Market Orders. Indeed, there can be no such evidence.

Under the theory of end-product pricing, the difference between a plant’s selling price and its cost of milk (whether expressed as cents per pound of cheese or cents per hundredweight) must cover all operating costs, or the plant will lose money and could eventually cease to exist. The Department properly adopted this philosophy and policy position in the Class III-A proceeding. 58 Fed. Reg. 58112 (October 29, 1993). In order to avoid this permanent loss of money and putting out-of-business scenario, the gross margin must include every aspect of the plant’s costs of operation, from the time it picks up the milk forward -- including any shortfall between the plant’s selling price (FOB the plant) and the NASS survey price (the average selling

FOB selling price across the country) and a return on investment and the cost of capital. *See* Part II.D, above. For plants in the West, the greater costs of transportation to market (as more fully discussed later in these Comments) makes that difference between Western plant prices and the NASS survey price particularly burdensome. Accordingly, the suggestion in the Recommended Decision particularly erroneous in suggesting “minimal impact” on Western cheese plant operators.

NDA stresses this point, today, because NDA testified at the hearing, and wrote extensively in its post-hearing brief, identifying ways to avoid “confiscatory” approaches to the make allowance, and articulating the approaches used in California. These comments were essentially ignored in the Recommended Decision.

The Department's sleight of hand in acknowledging last year's injunction regarding the price of butterfat, but then shifting any increased price for the Class III milk to the solids portion of the equation, results in a huge reduction in the gross margin available for processors, below that level which can meet the requirements of the Fifth Amendment.

2. *The Department has failed to define or enunciate a rational system for establishing manufacturing costs.*

A reader of the Recommended Decision might well conclude that in the current proceeding USDA simply accepted the RCBS cost numbers and used an average to establish the critical make allowance numbers that determine whether the pricing formulas allow profits, or are confiscatory. While California make allowance data was used to adjust the RCBS number, NDA strongly urges that applying a simple or weighted average of the RCBS plant cost data should not be adopted as USDA's methodology. Indeed, such an approach would be dangerous, for many reasons:

- Each of the surveys discussed during the hearing (the RCBS survey, the NCI-sponsored survey, and the State of California's survey) all necessarily use book depreciation numbers. Depreciation generally reflect historical acquisition costs of equipment and construction, but those historical costs may no longer reflect today's values for the same plant. For that reason, using historical cost reflects pre-inflation dollars makes it unlikely that the make allowance number can cover the depreciation associated with a new plant. New investments would dry up.
- This "basis" for depreciation can become somewhat arbitrary. Decisions about what costs to capitalize (and depreciate) versus what to expense during the year of construction can vary -- and that affects depreciation that is booked in the future. Also, there are times when that "basis" for depreciation can be "stepped up" for accounting purposes. The step up in basis normally would be to something like the fair market value, but in fact it can be higher depending on the desires of the parties involved. The result is that the same operation could legitimately report lower depreciation costs one year, and higher the next – due to an accounting artifice (a step up in basis) that underscores the arbitrariness of, and the danger of using, depreciation numbers. Tr. 1810.
- Even if the basis for depreciation were "right" (whatever that means), the period of time over which an asset can be depreciated may vary with tax laws or management philosophy – another somewhat arbitrary feature that may differ from sound economics.
- As a final comment on the narrow subject of depreciation, it should be noted that typically depreciation schedules are for a shorter period than the useful life of plants and major equipment. As a result, an older plant may report to RCBS virtually no depreciation, which would distort the type of survey that RCBS uses.
- There is also a necessary arbitrariness in allocating costs within multi-product plants, among the various products.
- Many participants in the hearing pointed out that the "cost" factors reported in these surveys seem to be highly variable, which casts some doubt on the accuracy with which they were prepared.

- Even if all the above factors could be somehow corrected, and “accurate” numbers could be developed from “statistically valid” surveys, there would still remain a key philosophical and Constitutional question: Is it permissible to set the conversion cost allowance at an “average” – which thereby necessarily would generate a milk cost so high (relative to the commodity market) that, literally, *half the plants in the country would not be able to recover from the marketplace their cost of converting raw milk into finished products?* Certainly not! If a plant with higher than average costs is not able to achieve more than the NASS survey price from the marketplace, the make allowance becomes confiscatory and the plant eventually will fail. Condemning half of the plants to an operating loss in no way ensures a healthy processing industry, or a market for dairy producers. Furthermore, it would not meet the Fifth Amendment “taking” standards.

In developing the Federal order pricing formulas in the Final Rule, USDA benefited from (and improved upon) the State of California’s experience with end-product pricing. One aspect that USDA did not consider is that California has routinely applied policy judgments in establishing an appropriate “make allowance”. As discussed at the hearing by witnesses Vanden Heuvel, Schiek, and Marshall, these policy considerations (which can at times be contradictory) include, among other things: encouraging processing efficiency, attracting sufficient processing capacity, sharing the benefit of higher prices between processors and producers. California seems typically to look at the array of costs shown in the survey, and set the “make allowance” at a level that includes most of the processing capacity but excludes the plants which are significantly out of the main part of the array. Perhaps the clearest point is that California does not arbitrarily compute and apply a simple average (nor a weighted average) processing cost. Tr. 1794; Exhibit 54-3A and –3B. For USDA to use a simple average risks half the industry

Finally, NDA stresses the importance of “harmonizing” all elements of the end-product pricing formulas in the methodology that USDA adopts. For example, “minimal packaging” is

assumed by NASS in the reporting of prices (Exhibit 22). Accordingly, the cost survey should sing the same tune and reflect only minimal packaging costs. Regrettably, the RCBS survey does not attempt to “harmonize” the RCBS methodology with what NASS does, and in fact assumes a higher packaging cost than does NASS. Tr. 99-101.

An additional illustration of this concept of “harmony” can be drawn from some of the testimony and cross-examination during the hearing, about yields. Some have suggested that modern plants achieve somewhat higher yields than once was the case (which NDA believes to be true). On the other hand, that modern technology costs money, to invest in the equipment necessary to obtain those higher yields. The system would not be in “harmony” if old plants (without such technology) were included in the survey plant operating costs, but the formula’s yield numbers were to assume the efficiencies that can be achieved only with (higher cost) modern technologies.

Until a “harmonized” system is developed, we are inevitably dealing with rough numbers, with lots of inconsistencies contained within them. Given that imprecision in the data sources, it is even more imperative not to arbitrarily compute and apply an average of whatever numbers might show up in that process.

3. *The Department fails to consider all transportation costs experienced by federal order manufacturers.*

Implicit in the “FOB” concept of the NASS survey and Federal Order pricing, is that if two different plants sell to the same market at the same price, their reported price that is used in the NASS survey can be quite different, depending on the delivery costs that are incurred. If the plant’s transportation costs to market are greater than those reflected at plants making up the NASS average, then that additional cost depletes the “implicit make allowance” or gross margin

available for that plant. Plants with less than average costs of moving their product to market (i.e., those in the East nearer to their market) would have an advantage in this respect, while those in the West who typically move cheese across country bear an inherent disadvantage in that respect. Tr. at 1797-1801.

Any end-product pricing system must take into account the cost of moving goods to market. Even under the Department's recent practice of establishing a single class price, undifferentiated geographically, it must be acknowledged that such transportation costs exist, and that the plant will fail if the explicit make allowance (or the implicit allowance computed as a gross margin) is not adequate to allow the product to be shipped to market.

The evidence is uncontroverted that cheese is sold where consumers are, that half of the nation's people live in the Eastern time zone, and that cheese plants in different parts of the country incur different transportation costs to move their cheese to market. Tr. at 1795-1800. Not surprisingly, then, the NASS survey shows lower plant selling prices in the West (as discussed elsewhere, in connection with the California price comparison).

In developing the Federal Order Class III price, an average NASS price is used. The Recommended Decision develops a methodology that assumes that all cheese plants do or should receive this national average price – it inquires no further into the negative impact that assumption has on plants in the West. Our cheese is assumed to receive the national average plant price, which assumes an average transportation cost. This ignores the realities testified to at the hearing and supported by the Cornell model of location values, which is reproduced in part in Exhibit 54-4. That sophisticated transportation model developed a “location value” for a cheese plant in Elmira, NY that is \$.65/cwt higher than the corresponding value for the

WestFarm Foods plant in Sunnyside, Washington. That suggests a transportation cost of 6.5 cents per pound to move a carload of cheese from Sunnyside to New York.

4. *The Department erred in developing the yield factors used in the Class III formula.*

NDA has reviewed the work being submitted to the Department by the International Dairy Foods Association and by Leprino Foods, and NDA endorses the technical comments therein regarding fat retention ratios and other technical factors. NDA wishes to expand, in these Comments, on our view that the Recommended Decision improperly considered the plant losses experienced by Federal order manufacturers.

The most appropriate place to begin this discussion is by observing that all aspects of the pricing formula must be “in harmony”. That would mean, for example, that if the yield factor assumes a plant loss, that loss should not be double counted in the plant operating costs that go into the make allowance (or, conversely, that if the development of the yield factor assumes it is in the make allowance, then the make allowance accounting should not simultaneously assume it is in the yield factor).

Somewhere in the system of yields and make allowances there must be some factor allowing for the milk that is left behind when milk is picked up from a farm milk tank – some residue is left, which is why FDA and the states require the farm tank to be washed up. Similarly, there must be some factor for the milk left in the tank truck that brings the milk from the farm to the tank – again, there is a reason why FDA and the states require that transport tanker to be washed. In both cases, some of the milk which the producer is paid for gets left behind and never gets into the plant.

And then there are losses within the plant, since some of the milk is lost during cleanup and some of the product is lost in the packaging process. The Recommended Decision simply makes no allowance for such losses within the yield factors used in the new Class III formula. That is the danger of using a theoretical construct without clearly analyzing where each piece of the cost structure is accounted for. Regrettably, the RCBS relied upon by the Department plainly does not even attempt to address these real life issues. Dr. Ling, who compiled the RCBS study, acknowledged during his testimony that he did not change his historical approach to the RCBS survey to make it more helpful for the purposes of this hearing. Tr. 74. Indeed, the implication of Dr. Ling's testimony is that nobody within the Department even suggested it to him! There is simply no evidence in the record that his numbers address. Tr. 73-81, 90-107, and 109-154.

In the Recommended Decision, there is a discussion about "shrinkage allowances" in the Federal Order. 66 Fed. Reg. at 54075. It is said that shrinkage need not be considered in the yield formulas, because it is allowed for elsewhere. That is mistaken, and clearly erroneous. Such shrinkage is merely reclassified to the lowest priced class, it is not forgiven. 7 C.F.R. § 1000.43(b).

Moreover, the statement in the Recommended Decision that the orders have always had provisions, which provide an allowance for shrinkage, is misleading. While the orders account for the difference between a plant's ticket weights and test (receipts) and its skim and cream use, the orders do so only to allocate skim and butterfat to its appropriate classification. No credits for losses between a farmer's bulk tank and a Class IV handler's churn and dryer are ever forwarded to a handler. Such yield losses by a processor are not addressed through the orders

and do represent a cost (see, for example, the testimony of Paul Christ and Robert Lenahan, among others).

Prof. Barbano's theoretical model (discussed in more detail later in these Comments) did not account for farm-to-plant shrinkage, as he acknowledged under cross-examination Tr. 659-661. Nor does it account for any plant cleanup or packaging losses, as can be seen by a review of his methodology, which is based on the Van Slyke cheese yield formula – a concept which has no relationship to issues of post-vat handling. Yet those are very real, and inevitable, losses that must be considered either as a reduction in yield, or a separate cost to be put into the make allowance.

Clearly, the make allowance discussions in these proceedings do not include those factors. One reason this might be so is that the industry was not prepared for the government to call an expert witness who himself was not prepared to address all of the factors and whose proposal was then disallowed by the Administrative Law Judge. To permit the Department to shift course on this basis would be improper and unlawful. In particular the issues of farm-to-plant losses and post-vat losses should have been considered in the yields that a plant receives from a cwt of cheese. This is indicated in the testimony of industry witnesses -- for example, Dr. Bob Yonkers. Tr. 297. The yield factors that have been in the Class III formulas up until now have seemed reasonable to plant operators, so there was no emphasis put on this by the industry during the hearing.

The Department now proposes to change those factors, so that they include no allowance for farm-to-vat shrinkage, and to clarify (for the first time, to the best of our knowledge) that such plant loss costs "should" be part of the make allowance. The Recommended Decision states:

Both the CDFA and RCBS cost surveys allocate all plant costs to actual end products, a process which should take shrinkage into account.

66 Fed. Reg. at 54075.

That is a **new concept**, that would change the industry's understanding of how make allowances are to be structured, a concept that probably will surprise Dr. Ling himself! The more fundamental problem with that concept is that it is simply not supported by the evidence, and to a significant extent is contradicted by the evidence! The California cost survey (Exhibit 27) has no explicit breakout of plant losses in its cost categories, and Dr. Schiek specifically testified that "the raw milk value associated with shrinkage" is not included in the California methodology. Tr. 1161. **None of the cost categories in Dr. Ling's RCBS study (see Exhibit 9) would suggest to the plant accountants who respond to the RCBS survey that plant losses of milk or cheese should be included.** The reporting plants who in their accounting systems consider shrinkage as a factor in their raw product costs would not have included it as a plant cost, even if they break it out separately.

Readers of these Comments are invited to open up the electronic version of the transcript (available on the internet) and use the "find" tool within Acrobat Reader to examine the testimony of Dr. Ling, who prepared the RCBS cost survey. The word "shrinkage" does not appear in his testimony. The only discussion of the issue was during Dr. Ling's cross examination by Mr. Vetne, about the cheese yield numbers in his survey. Dr. Ling acknowledged he did not know anything about how those numbers related to plant losses, only that he reported what the industry had reported to him as their yields. Tr. 132-135. Note, however, those reported yields -- which Dr. Ling included in the RCBS survey report (10.3 pounds of cheese per cwt) -- are totally meaningless for purposes of this rulemaking proceeding

because there is no indication of the component values of the milk going into the plants that reported that simple average yield number. The only way to judge the pounds of cheese made from a hundred pounds of milk is to know the pounds of protein and butterfat contained within that hundred pounds.

USDA should follow the conventions used by industry, and include pre-vat milk shrinkage as part of the plant yield. Instead, , in the Recommended Decision, the Department has decided that the make allowances “should” include plant losses (regardless of whether the numbers in evidence do or do not). This has radically changed the Class III cost structure for processors, based largely on a theoretical model from academia which assumes shrinkage away by assuming a “perfect” Van Slyke vat yield! The result is that the Recommended Decision proposes a Class III formula that is so unrealistic and confiscatory, that few cheese plants will be able to live with it.

5. *The Department fails to consider the potential competitive harm Federal order manufacturers would suffer, if the dramatic price increases proposed in the Recommended Decision are adopted.*

As noted in the Recommended Decision at 66 Fed. Reg. 54068, the Department’s economic model indicates that the revised Class III formula will increase the Class III price by \$.38/cwt, varying from \$.23 to \$.48 with changes in the market value of butter. At 66 Fed. Reg. 54087, this number seems to be estimated at \$.48/cwt. Whatever the number, it is clear that the manufacturer can never pass this increase on to the marketplace. That follows from the way the Federal Order Class price is established: the product formula is based on the market price, so if manufacturers increase their selling price to try to capture costs, the NASS survey price increases accordingly, and the Class price rises correspondingly.

For that reason, the \$.38 or \$.48/cwt increase in the Class III price represents an unjustified and unexplained reduction in the gross margin for cheese, an increase that translates (assuming a yield of 10 pounds of cheese per cwt) to roughly 3.8 cents per pound of cheese (or 4.8). This is in every practical respect the equivalent of a disguised 3.8 (or 4.8) cent reduction in the make allowance. By comparison, the cheese make allowance in the Class III formula is presently stated as 16.5 cents per pound. Thus, the 3.8 (or 4.8) cent per pound disguised reduction proposed in the Recommended Decision represents a whopping 23% (or 29%) decrease in the effective make allowance within which cheese manufacturers can operate. That is a huge change, yet the Recommended Decision fails to adequately address it or recognize its significance.

The potential consequences of such a dramatic increase in Class III will be most harmful in the westernmost Federal Orders (124, 131 and 135), where two factors work against manufacturers located in those regions:

- First, western cheese manufacturers are further from the population centers east of the Rocky Mountains, and (as suggested above and shown more clearly below) face greater transportation costs that deplete the fixed gross margin.
- Second, western cheese manufacturers whose cost of milk is established by Federal Order class prices must compete against California cheese plants who already enjoy a competitive advantage relative to Federal Order plants. (NDA Testimony at Tr. 1792.) At the May, 2000 hearing, Official Notice was taken of the two different price series.

*6. The Department has failed to consider price alignment with California, and the competitive inequity that would result from the Recommended Decision, and in so doing departs from past Federal order decisions by ignoring the impact that the California system has on national manufacturing prices and upon processors in Federal orders.*

The issues presented by California are mind boggling in their degree and extent, and reflect a substantial worsening of a longstanding concern for Federal Order supporters in the West.

NDA's calculations from the officially noticed material establish that from 1996-1998, during

the debate over Federal Order “reform”, the Federal Order Class III averaged \$13.21, while the corresponding California Class 4b price averaged only \$12.65 over that three year period. This very significant competitive advantage for California cheese plants was a topic of much discussion during the “reform” discussions. As discussed in Part II.A. above, the Department has in past decisions recognized and addressed this concern.

a. History of California-Federal order price relationships.

During 1999 (just before Federal Order “reform”), California made some changes, and their state system’s Class 4b price that year averaged \$12.36, nearly at parity with the Federal Order system’s Class III average of \$12.43. And under the initial “reform” Class III formula there was once again a near parity – with the Federal Order Class III at \$9.74, a nickel higher than California’s \$9.69. Indeed, comments from USDA (both during the informal rule making and in the record, as will be quoted below) suggested that one of the Secretary’s goals at the time was to improve the price alignment with California. And there was good reason for this: Professor Ron Knutsen (who served as an academic advisor to the Department) made quite clear in his presentations to both USDA and Congress his view that neither system can survive if there is not price alignment. He is correct!

Unfortunately, that move toward price alignment under the “reform” process has changed, and it is getting worse.

First, the Class III formula changes established in the Federal Orders a year ago, under the post-injunction Tentative Final Decision, widened the chasm between Federal Order and California manufacturing prices. In 2001, the Class III price has averaged \$13.10 versus only \$12.61 for California’s Class 4b (a \$.49 disparity).

In addition to USDA's changes early in 2001, during December, 2001 the State of California increased their make allowance on all class prices in their state order, except fluid, to reflect higher energy costs. As a result, the Class 4b price (which applies to milk used to produce cheese, and is therefore analogous to Class III in Federal orders), was lowered by 7 cents per pound. Federal order plants also face higher energy costs, but are having to absorb those increases. With that change, the 2001 disparity of 49 cents/cwt now will be approximately 56 cents. (Official Notice was requested of CDFA modifications available to the public on the CDFA website. The current version can be found on the internet at: <http://www.cdfa.ca.gov/dairy/classa4b.html>).

Now, in addition to that, the Recommended Decision threatens to add perhaps \$.48 more to this \$.56 disparity (depending on butterfat price levels). This will give California cheese processors as much as **\$1.04 per cwt advantage** in pricing!

NDA's one cheese plant makes over 140 million pounds of cheese per year. NDA calculates that the proposed \$.48 change by itself would mean a hit of close to \$7 Million per year, to a company that hasn't been making that much money across all of its operations! This could have serious consequences for NDA (See Part II.D., above) and has the potential, when considered against the California advantage, to annihilate the non-California Western cheese industry.

b. Analysis of Difference between California and Federal Order prices for milk used to produce cheese and whey.

NDA has performed further calculations using record evidence, officially noticed materials and the recently modified California formulas (official notice requested) in order to

assess the competitive disadvantage with which Federal order cheese plants are threatened. The following factors must be considered in any comparison with California:

- California does not ascertain prices per pound of protein, but still uses nonfat solids.
- California uses a different price series to establish the market price, making comparisons with California difficult. California's price is based on the Chicago Mercantile Exchange cheese price (the CME), whereas Federal Orders use a NASS survey of plant selling prices. NASS does not adjust for geography, except in that the prices are "FOB the plant". As noted on page 35 of the internet version of the Recommended Decision, California deals with this by applying a transportation factor of 4.5 cents/cwt (presumably the cost of moving cheese from California to Chicago) to lower the cheese price an additional 1.2 cents/lb to reflect a historical difference between the CA cheddar cheese price and the CME.
- Further complexity arises because the California system announces monthly prices based on prices through the 25<sup>th</sup> of each month, from the 26<sup>th</sup> of the prior month . . . whereas NASS surveys are based on four or five calendar week periods that almost always differ slightly from the period California uses. That makes monthly comparisons difficult, but should be insignificant in longer term comparisons.
- The final factor which makes comparisons difficult is that the newly proposed Class III formula would, if the Recommended Decision is followed, create different Class III skim solids prices at a given cheese market price, depending on the market value of butter. California's Class 4b formula (which is described in the hearing record, and which has not changed since the hearing) uses a whey butter factor that impacts the solids portion of the class price differently than the newly proposed Federal Order factor.

The differences just identified make it difficult but not impossible to compare the impact of the Class III formula being proposed in the Recommended Decision, against the California price. A theoretical model is the best way to gauge the potential differences. To assist in that analysis, NDA has prepared three tables which are attached to these Comments:

- The first (Table A) shows the Federal Order Class III prices that would be generated at various combinations of butter and cheese prices, assuming that the NASS whey price averages 23 cents per pound. (The \$.23 is the average of the 2000 and 2001 whey prices.)
- The second (Table B) shows the California Class 4b prices that would be generated at the same combination of cheese and butter prices. Whey prices are not considered in the California formula.
- The third (Table C) shows the differences in price between the first two tables, at each combination of butter and cheese prices.

This theoretical model prepared by NDA shows differences of \$.72 to \$1.03 per cwt. With a “typical” cheese price of \$1.40 per pound and a “typical” butter price of \$1.50, and with a \$.23 whey price, the difference would be \$.87/cwt. That number should then be reduced by \$.15/cwt, to reflect the historic difference between the NASS survey price of cheese and the CME price used in California – California is higher by 1.5 cents/lb. The net difference over time (the true competitive advantage) is shown to average \$.72/cwt.

As discussed earlier, there are other differences between the Federal and California pricing systems that the Department has utterly failed to explore and explain.

The differing treatments of whey may be the most unpredictable difference between the two systems, because of the volatility of the whey price. Reducing the assumed whey price in the model from \$.23 cents per pound (a rough midpoint of whey prices the past few years) to \$.18 (more typical of the years 1999 and 2000) reduces the difference between the two systems to “only” \$.51/cwt. But using a whey value of \$.28 cents/lb (typical of this past year) puts that difference to \$1.09 per cwt. That would be a simply untenable difference between the two systems!

Another difference that is particularly important to cheese makers in the West is the treatment of location values. The NASS block price is predominantly weighted toward the West. At one time the Western prices were broken out separately, but they are now shown in the “other” category because the “other” became so small. A fair interpretation of the NASS data is that cheese plants in the West (as reflected in the “other” price) is about 5 cents per pound lower than the price received by plants in the Minnesota-Wisconsin area (actually, .0595 during calendar 2000, and .0375 during calendar 2001). Assuming that it takes 10 lbs of milk to make a pound of cheese, that 5 cent difference in what plants receive for a pound of cheese effectively

means a 50 cent/cwt difference across the country in the price of milk, as you move from West to East within the Federal Order system. In California, this location factor is specifically acknowledged, with a \$.045/cwt transportation adjustment in their Class 4b formula.

For the reasons described above, it is clear that the disparity between the Federal order system and the rules in California -- the nation's largest dairy producing state -- will be a significant boon to the California cheese industry, which will enjoy a competitive advantage over time of (NDA's numbers indicate) \$.72/cwt, or 7.2 cents per pound of cheese. The number developed above from last year's data (reflecting last year's market conditions) would have been \$1.04, or 10 cents per pound. That is an extremely significant hurdle to overcome, in a market where the cheese price typically fluctuates in the \$1.30 - \$1.50 range (6 cents would give California processors a four percent cost advantage over companies like ours.

c. Importance of Price Alignment.

The importance of alignment between the California and Federal Order class prices was specifically noted by the Department in early 1999, in the Final Decision of the "reform" process. 64 Fed. Reg. 16026 et seq. (April 2, 1999).

Within the section of that document analyzing the "Basic Formula Price and Other Class Price Issues, alignment of Class III and 4b was discussed in the following excerpt:

In addition to comparing the Class III and Class IV price series to the current BFP, the Class III price was also compared to the California 4b price . . . . Comparisons to the California prices are included because many commenters expressed the view that the proposed rule resulted in prices that put plants regulated by Federal orders at a competitive disadvantage to California plants and that alignment with California pricing was essential. Most commenters did not express the view that Federal order prices should equal California prices, but that Federal order prices should be in alignment, i.e. "reasonably close".

*Id.* at 16100.

That discussion within the Final Rule proceeded to observe that the study being used to make that price comparison found that: “For the period January 1994 through December 1998, the Class III price averaged . . . \$0.20 above the California 4b price . . . .” It was then noted that the new Class III formula had a correlation coefficient of .97 with the California 4b price. *Id.* at 16101.

In contrast, Section 3.d of the Recommended Decision in this proceeding (66 Fed. Reg. at 54085), where the effects of the changes in the Class III formula are discussed, does not mention, even once, the word “California” – an omission which is particularly curious given the Department’s reliance on California data in establishing the explicit make allowances and in establishing the Class IV yield factors.

It is important to recall the admonition that is widely heard throughout the industry that unless there is price alignment between California and the Federal orders, neither system can survive. 64 Fed. Reg. 16100. If the Federal order system compounds the problem by ignoring California, and tightening the Class III formulas so that it can be \$.80 to \$1.00/cwt above the California Class 4b price, it must be seen as clear indifference by the Department to the Western dairy industry, notwithstanding the Fifth Amendment issues (described in Part II.D., above). The regionalism that has plagued dairy policy for so long will be exacerbated, as those suffering in the West observe the partial competitive insulation that the Eastern and Midwestern cheese industry will enjoy because of their distance from California and their closeness to Eastern markets.

For example, in its most recent hearing (similar hearings were given official notice at the hearing in this proceeding) the state of California specifically determined in March of 2001 not

to add a whey factor to their Class 4b formula (which would make it more like the Federal order system), noting that:

In order for California cheese to be competitive in the nation's largest cheese markets (Eastern U.S.), California cheese must be priced somewhat lower than cheese produced in states that are closer in proximity to the markets.

See <http://www.cdfa.ca.gov/dairy/hearings/DecisionLetter052201.htm>.

It can not be the conscious belief of the Department that the cheese industry in Federal orders in the West should be driven out of business. However, that is the likely practical effect of the approach taken in the Recommended Decision. And if the Department truly believes that Western cheese plants must be 8-10 cents per pound of cheese more efficient than the average plant across the country (or we shouldn't be in business), then please say so in a Final Decision, so that other policy makers will fully understand the Department's rationale.

*7. The Department Erred in analyzing the impact of the Recommended Decision.*

In discussing the potential increase of \$.48/cwt in the Class III (Id. at 54086-54087) the Recommended Decision in this proceeding relies only on two bits of evidence from the hearing record:

- Professor Barbano from Cornell observed, while discussing his theoretical model, that the market value of cheese plus whey cream plus whey powder exceeds the sum of the milk price and the make allowances as he calculates them. Tr. at 581-582. We do not challenge Professor Barbano's familiarity with the East Coast cheese industry, where his theoretical model may have some practical application, but he did not attempt to discuss the implications of this for our Western region. Furthermore, his theoretical model does not take all Fifth Amendment factors into account.
- In the final paragraph of the commentary, this Recommended Decision notes that a \$.48/cwt difference would be expected where milk has the component content in the Upper Midwest, and comments with respect to the \$.48 reduction in the gross margin as follows: "Also, the lower gross margins under the recommended formulas could lead to reduced over-order premiums to reflect increased milk costs and maintain current gross margins."

The latter comment reflects an “East Coast perspective” that ignores the differences between the cheese industry in the West, versus that portion of the cheese industry which lies within the population centers in the Central and Eastern time zones. For example, there is no evidence in the record, nor anywhere else, to indicate that there are over-order premiums being paid by Federal Order cheese plants in the West, even though premiums apparently do exist in the East and Midwest.

The Recommended Decision ignored the **uncontroverted evidence** submitted by cheese manufacturers “out West” – one can search the Recommended Decision in vain for references, much less an explanation for not considering either:

- Testimony by Jeff Williams of Glanbia Foods and NDA regarding the transportation costs faced by Western cheese plants to move the cheese from the West (where NDA produces it) to the eastern markets (Tr. 1797); or
- The Cornell study of location values, which was developed for the “reform” project, and which demonstrated that there is a significantly different value of milk used to produce cheese in the West, because of the distance cheese must move to get to the population centers in the east. Exhibit 54-4A and 54-4B. Note that this is the same Cornell study that was relied upon by the Secretary during the “reform” process to establish the location value of Class I milk.

The Cornell study of location values demonstrates why there would be room for over-order premiums in the East and Midwest, while no such room in the West. That study, of which official notice was taken (Tr. 1796), reflects only differences in transportation costs, and it shows a freight-based differential in Class III value between the Midwest and NDA’s Sunnyside, WA cheese plant (37 to 40 cents/cwt, varying seasonally). This can be seen in Exhibit 54-4A. This theoretical difference of 37-40 cents would indicate there is room for over-order premiums in the Midwest, without there being any in the West. It is myopic and erroneous for the Department to conclude (as it apparently did) that there are over-order premiums throughout the country.

What the Recommended Decision has done, however, is to ignore all that and to assume that there are over-order price premiums being paid in the West, out of which an increase in the Class III price can come. This is simply unsupported in the record, and unsupportable in fact.

Turning to the Department's apparent reliance on Professor Barbano's testimony to raise the Class III price, we respectfully urge that such reliance was also erroneous.

Professor Barbano testified regarding his concept of how much milk can be obtained from milk of different composition. Part of his testimony was a spreadsheet (Exhibit 17, which is available in interactive form via the internet through Exhibit 15 on the Department's web site covering this proceeding). The spreadsheet uses some research known as the Van Slyke formula, to estimate theoretical cheese yields. There are a number of problems with his model, some quite technical and complex, which are discussed in these Comments and by others in their Comments, and in which NDA joins.

What is important in this context, however, is to recognize that Professor Barbano's model is not very helpful for the analysis for which it is used in the Recommended Decision. **Reduced to its most simple summary**, the Professor is basically saying that if a cheddar cheese plant starts with a hundredweight "standard" milk of 3.5% butterfat and 2.99% true protein, he thinks the manufacturer will get more cheese from the hundredweight than USDA assumed in the yield assumptions that are in the Department's Class III formula that became effective January 1, 2000. In other words, he suggests his yield assumptions are more accurate.

To his credit, however, he also noted that others might disagree, and he offered his model on the Internet for students and hearing participants to play with, using different assumptions. Certain "cells" on the spreadsheet (those in blue) can be modified so that the user can test his or her own assumptions.

What Prof. Barbano clearly was NOT assuming is that he was totally right. Yet the Recommended Decision does! It uses his initial yield assumptions (for example, a .90 fat recovery factor, and a 1.09 “nonfat, noncasein solids factor for Van Slyke Yield”). If an academic colleague does not agree with those factors, she could use the computer model to alter the assumption. But there is no suggestion in the Recommended Decision that any other such factors were considered, nor why these were selected, to be used in the test of reasonableness of the Department’s new and different Class III formula. This simply makes no sense!

Still, it is useful to follow through with the model in its initially presented form, to see why it would not support the Recommended Decision, even if it were accurate. Using Prof. Barbano’s initial yield assumptions, his computer model (Exhibit 15) computed a price for March of 1999 of \$11.6591, whereas the Department’s formula at the time calculated \$11.51 as the milk price. Tr. 580. If his formula is correct (which it’s not), it would indicate \$.15/cwt in “missing” money that he assumes is a windfall for the processor. So, **even if true**, that would not justify the \$.48 increase created by the Recommended. It’s short by a factor of three!

The next problem with using it to justify an assumption about the new Class III formula is that it is not the same as the proposed Class III formula. If the Department assumes his formula is the true indicator of raw milk value, why are they not using it? And if they are not, how can they use it to justify a different formula that they are using, without at least doing a similar analysis? They can’t, and the failure to do so is both lacking in academic rigor and legally unsupportable.

However, just for fun, let’s apply the “Barbano Test” that was endorsed in the Recommended Decision to the new Class III formula. He used the following prices (for March of 1999): NASS Cheese of \$1.3064, NASS Butter of \$1.3019, NASS Whey of \$.1917. Under the new

Class III formula in the Recommended Decision, the Class III would have been \$11.82. The old Class III (as Barbano noted) generated \$11.51, so the increase is \$.31/cwt under those market conditions. But at the hearing, the Barbano “test” of what was “appropriate” for March of 1999 was \$11.66. By Professor Barbano’s logic, then, the Recommended Decision generates a Class III price that is too high. That delightful irony aside, the more serious point which NDA must stress is that the preceding paragraphs demonstrate a clear error in one of the assumptions used in the Recommended Decision to “prove” that the marketplace could handle a \$.48/cwt increase in the Class III price. It just doesn’t work, and should be entirely reconsidered.

More fundamentally, the problem with Prof. Barbano’s spreadsheet is that it is simply not good evidence. Professor Barbano’s argument about the value of milk that should go to the producer, versus the processor, is just that – argument, and it is based solely on a theoretical model. It is not evidence of actual processor margins under the January 1, 2001 Class III formula. It is entirely theoretical, not grounded in any real world data. It is, in an evidentiary sense, just one man’s opinion ... unsupported by any evidence other than the theory.

Moreover, his spreadsheet was offered to support his proposal, but his proposal was subsequently ruled not to be a part of the hearing (and which therefore was not focused on by the industry in post hearing briefs). Tr. 1796. In effect, use of the spreadsheet “bootstraps” a formula that could and should not be considered for the hearing.

Yet another very clear problem with relying on it is that the theoretical model may not be accurate to predict the real world. It is clear that if his theory does not take into account something essential, like shrinkage, it is worthless. During cross-examination, the question of farm-to-plant losses was raised, and he acknowledged that they were not part of his model and therefore would have to be accounted for in the make allowance. Tr. 660- 661. The problem

with that is that there is no evidence that the make allowance is computed to allow for shrinkage, as discussed above. So unless the rest of the Class III formula has been redesigned around his theory and his assumptions, and there is no reason to believe it has, it simply can not be relied upon to evaluate that formula. And the one thing we do know for sure is that Professor Barbano is not clear on how the rest of the formula works:

- Specifically, the formula uses the Class III make allowance number, but **nobody** knows what properly must be accounted for in the make allowance, and indeed Professor Barbano testified that “[i]t would be useful to have a clear description of what is included and what is not.” Tr. 541. In fact, Professor Barbano testified “I am not taking any position on what the make allowance should be.” Tr. 534. If he is not addressing that, he can not be addressing how the “missing” money should be divided.
- Professor Barbano’s testimony also emphasized, in bold, that “[a]**ccuracy of the NASS cheese price is critical.**” Tr. 562. It is fair to say that his testimony did not further explore the NASS survey transportation factors that were emphasized in these Comments, above. Stated another way, Professor Barbano never attempted to address the relationship between the assumed market prices and what plants actually receive (due to factors such as different location values of cheese plants). In order for his testimony to have any use, it is necessary to know whether he agrees or disagrees with the implication of the study his colleagues at Cornell had offered, in connection with differing location values.

Since Prof. Barbano testified that he was not taking a position on what the make allowance should be, and because the Administrative Law Judge excluded his proposal and since he wasn't prepared to discuss all Fifth Amendment elements of the make allowance, his testimony and its impact is of severely limited value in meeting the APA substantial evidence requirements. It was error for it to be used in the Recommended Decision to justify the reasonableness of the new Class III formula.

*8. Summary of Position regarding Class III formula.*

What is particularly urgent to NDA and to others here in the West is that the failure in the Recommended Decision to recognize their greater costs to transport cheese to market (discussed

above) is compounded by the departure from prior decisions in ignoring the need for price alignment with California. This is particularly distressing to those in the West, because the State of California is clearly very much on top of these issues of transportation, and distance to market.

The Recommended Decision takes the wrong approach. USDA must not turn its back on Western cheese plants, and must not foster such a regional conflict. Instead, there are many ways in which this can and should be avoided, but in general the “harmonious” system of end-product price assumptions, make cost assumptions, and yield assumptions all should be structured with enough “room to operate” that a plant in the West can overcome the greater transportation costs inferred from the Department’s own NASS survey, and confirmed from the Cornell model of location values. Specifically:

1. Farm-to-plant and post-vat losses must be recognized in the Class III (and IV) formulas, either through an increase in the make allowance or in the yield assumptions inherent in the formula.
2. Others who are more familiar with the details of cheese yields (Leprino Foods, IDFA, Agrimark, and Kraft) are submitting comments that NDA endorses and incorporates herein by reference, which offer a more sound, and more fact-based, foundation for a Class III formula.
3. The gross margin should be reasonably competitive with that in California. If it is not, the Federal Order system could become more harmful than helpful in the West.
4. The spread between blocks and barrels is overstated by 2 cents. There is simply no record evidence of cost data that supports 3 cents. Moreover, since the historic price spread has been altered by the restatement from 39% to 38% moisture, the Department must reflect that change in the formula.

For these reasons, NDA urges the Secretary to reopen the hearing, reconsider all these issues including especially the changes in the California Class 4b formula, and develop a more sound Class III formula.

B. Class IV Formula.

NDA also takes exception to the Class IV formula adopted in the Recommended Decision.

NDA's concerns are similar to those set forth above with respect to Class III:

- Farm to plant shrinkage is not explicitly included within the make allowance or yield factors.
- Treatment of post-processing product losses is also not explicitly included in either the make allowance or yield factors.
- As with Class III, the differing transportation cost factors facing butter and powder plants in the West, compared to those east of the Rocky Mountains, was not addressed.
- There is no consideration of Federal-California price alignment in Class IV..

The competitive situation with Class IV would be as follows. Under the Recommended Decision, the average difference between the Federal order Class IV and the corresponding California Class 4b has been \$23 over the past year. The recent California formula change (discussed above in connection with the Class III formula) will add an additional \$.20 to that disparity, creating a \$.43/cwt competitive equity problem.

The "California disparity" is especially of concern to NDA, because WestFarm Foods operates three drying plants, all relatively near the California plants (which produce 60% of the nation's powder) and competing for the same markets with similar transportation cost factors.

Moreover, as the operator of three drying plants, NDA emphasizes the importance of relating processing costs (the make allowance) to the purpose of the plant – a true "balancing" plant will not operate at full capacity the year around. Because it has idle capacity some of the year, it will have much higher operating costs over the course of a year's time. Since most balancing plants are drying plants, the Recommended Decision should have included an adjustment in the Class IV formula to recognize this.

When viewed along with the similar economic stress the Recommended Decision would create for NDA on the Class III side, the combined effect would be a very severe “double whammy” that the cooperative would have to take any available steps to avoid.

For these reasons, NDA urges the Secretary to reopen the hearing, reconsider all these issues including the new California Class 4a formula, and develop a more sound Class IV formula.

### C. Potential For Disorderly Marketing Conditions.

In the past, the Secretary has consistently addressed pricing issues such as those in this hearing with full consideration given to potential disorderly marketing conditions. The proceedings in 1991 and 1992 that established Class III-A (the forerunner to Class IV) were called by the Secretary largely because of imminent and existing disorderly market conditions that could now easily reappear if the Recommended Decision is implemented. In addition to the discussion in Part II, there are two parallels to the Class III-A situation:

1. The Class III price that had been in effect for NFDM was based on a pricing system that provided no “room to operate” for NFDM manufacturers. The result: forced losses, when plant operators could not recover their milk costs and operating costs from the marketplace.
2. The California state order had already addressed this issue with a separate price for their powder manufacturers. As a result, there was a huge price difference between the California and Federal order system.

The current rulemaking proceeding is in a very real way the grandchild of the Class III-A experience. One of the debates, during the “reform” process of the late 1990s, was whether to extend end-product pricing from NFDM (Class III-A) to all manufactured products, and of course the new Class IV resulted. This current proceeding alters once again the end-product pricing formulas for Class IV that were initially developed under Class III-A.

With all of the very detailed discussions in this proceeding about percentages of fat retention and the fractions of cents that a make allowance might need to reflect energy costs, it is important to stay focused on the larger purposes of the Federal Milk Marketing Order system. The statutory objective is to establish a fair price for dairy farmers, while preventing disorderly marketing conditions. In this proceeding, that means establishing a “fair” division of the wholesale value of milk products, between dairy producers and dairy farmers, while resolving – or at least not creating – any disorderly marketing conditions.

Regrettably, it seems clear to NDA that the Class III and IV price formulas proposed in the Recommended Decision would create disorderly market conditions within the Pacific Northwest, and perhaps elsewhere:

First, plant operating margins from our NDA’s manufacturing operations (butter, powder, cheese, and whey) would be diminished substantially (NDA estimates by \$7-8 Million dollars per year). Just as was the case when Class III-A was at issue, NDA would be buying milk at Federal order prices, but selling the packaged products at no more than the prices the California plants offer to NDA’s customers. And the result – forced losses – is similar to what led to the Class III-A proceeding a decade ago.

Second, because NDA is a cooperative, payments to member patrons would have to drop by \$ Million/year. That could lead member producers to leave the cooperative, to ship directly to NDA’s bulk milk customers, thereby jeopardizing NDA’s service charge income and further lowering NDA’s operating margins. Those dairy producers who remained within the cooperative would bear a proportionally larger part of the Class III and IV plant losses and the reduced operating income. The Department found this result to be unacceptable when it established Class III-A. It can not be acceptable now.

The potential scenario just outlined would, in turn, put the leadership of the cooperative in the uncomfortable position of having to make a judgment about whether the benefits to be gained from the Pacific Northwest Federal Order (some price enhancement on sales to bottlers) would outweigh the potential costs to those producers who remained members of the cooperative, and the risk of damaging the cooperative itself. In other words, if the lost income on Class III or IV, plus additional losses from a consequent loss of producers, are not made up for in enhanced Class I prices, the Federal order becomes a burden rather than an advantage.

Voting out the Pacific Northwest order is not NDA's goal, and it would not be NDA's first choice. But it could be a last and only real choice that would effectively be forced upon NDA, if upon review of the Final Decision in these proceedings the NDA Board of Directors determines they must choose between economic damage to the cooperative and keeping the Federal order.

The point of even bringing this up is to point out that "disorderly marketing conditions" are the likely result of the proposed Class III formula, whether or not the order is retained. When coupled with last year's changes in the Class IV formula, which also disfavor NDA, the prospect of voting out the order must be considered – and that clearly would cause an even more disorderly market in this region.

#### D. Butteroil Classification.

The Recommended Decision proposed changing the classification of anhydrous milkfat, butteroil, and plastic cream from Class IV to Class III. The original rationale for the changing the classification from Class III to IV was that these products competed with butter and needed to have a similar cost base for butterfat.

We believe that this is still true. We disagree with the Recommended Decision to return these products back to Class III. As long as the Class III and IV butterfat values remain the same, then anhydrous, butteroil and plastic cream should all remain Class IV products.

With the production of butter, all the cream used to produce butter is considered Class IV and the buttermilk generated as a byproduct of churning is also a Class IV product.

Administratively, this makes the task of recording utilization simple and straightforward based on the volume of cream used to produce the cream and buttermilk. If anhydrous, butteroil and plastic cream are changed to Class III products, then it would be necessary to separate out the buttermilk portion of the cream that should be classified as Class IV. It is important that nonfat solids found in buttermilk produced as a byproduct of churning butter should have the same underlying raw material costs as nonfat solids found in buttermilk produced as a byproduct of the anhydrous, butteroil and plastic cream operations.

Determining a method of allocating cream solids between buttermilk and the butterfat products would be an unnecessary complication that would be easily avoided by simply leaving all of these products in Class IV.

From the important standpoint of the viability of the Class IV futures market, keeping butter oil and plastic cream as a Class IV product enhances the volume and liquidity of the Class IV futures contract. NDA strongly believes that certain processed cheese companies use the Class IV futures market to hedge their input costs of those Class IV products that are used processed cheese manufacturing. NDA also use the Class IV market to hedge products. Moving butter oil and plastic cream to Class III could move much needed liquidity from Class IV futures, and transfer it to the Class III futures market.

#### IV. COMMENTS AND EXCEPTIONS

For all of the reasons set forth above, NDA takes exception to the revised Class III and IV formulas proposed for the Recommended Decision in this proceeding. Without waiving any issue discussed above, NDA especially notes:

1. The Recommended Decision is unlawful because:
  - (a) the proposals depart from prior decisions and reasoned analysis without explaining and justifying this departure;
  - (b) the proposals were made after Court intervention barring consideration of a separate value for butterfat calculated in the two formulas and without further record evidence having been taken, but resulting in even greater price impacts on manufacturers of Class III and Class IV products;
  - (c) the proposals fail to consider several relevant factors supported by the record and reach conclusions unsupported by the record;
  - (d) the proposals fail to meet the standards for rate making now undertaken by the Secretary for all Class III and Class IV products; and
  - (e) the proposals create as to NDA a trade barrier for sales of its manufactured products that is illegal under 7 U.S.C. § 608c(5)(G).
2. The Recommended Decision did not properly consider differences in transportation costs between cheese plants in the West (which must market to the east) versus transportation costs for cheese plants in the Midwest and East.
3. Potential differences of \$.50 to \$1.00 per cwt (as documented earlier in these Comments) between the newly proposed Class III price and the California Class 4b price would be very significant, and unwise as a matter of public policy. There is no indication within the text of the Recommended Decision that the issue of price alignment with California was ever analyzed, or even considered. Failure to consider price alignment would reflect a marked departure from the approach taken during the establishment of the current formulas, during the "reform" process (as documented and discussed above).
4. The yield factors in the Class III and IV formulas are in error because they do not properly consider farm-to-plant losses, or post-vat losses. Only in-vat losses are recognized in the yield. It is arbitrary and capricious to ignore the other losses in a system that effectively limits the gross margin of a plant operator and requires that such losses be covered within that gross margin.
5. The block-barrel spread cannot be justified at 3 cents. There is no record evidence to support this conclusion.

## V. REQUEST TO REOPEN HEARING

NDA respectfully suggests that much of the errors to which we have taken exception could be – and should be – corrected by reopening the hearing in these proceedings, to address the issues that are apparent, now that the industry has seen the methodology which the Department would like to follow. Specifically, the following types of information could be sought:

- What is the industry's view on price alignment with California (has it changed since the "reform" process during which the Department acknowledged industry concern about it?)
- What are vat yields experienced by industry? And how do they compare to total farm to package yields (losses).
- What is the relationship between vat yields and equipment age? Do plants with higher yields rely on more expensive technology? Do the make allowances assume those higher cost plants, or the cost of the older plants with less efficient yields?
- What are the non-vat losses that plants experience, from the time milk is bought on the farm until the time the finished product is delivered to the customer? WestFarm Foods is currently undertaking a substantial internal study of its plants' total shrinkage (butter-powder as well as cheese) that could be offered into evidence at a reopened hearing.
- USDA has recently "tilted" the relationship between purchase prices for butter and powder, under the CCC's dairy product purchase program. This tilt implies USDA's CCC wants the industry to make less powder, which signals the industry to make cheese, but the Recommended Decision would discourage the production of cheese in the West, where so much of the powder is made. How does the Department coordinate policy? Aren't the two programs, administered by the same agency, working at cross purposes?

In addition to this request, NDA is aware that there have been other requests that the Department reopen the subject to make allowances, especially with this past year's change in energy prices. California has acknowledged those changes, and the Federal Order system must consider them as well.

NDA joins in those earlier requests for a reopened hearing, and urge one be called at the earliest possible date, to provide more current information on all matters relating to these proceedings.

## VI. CONCLUSION

NDA appreciates the Secretary's and the Department's consideration of its views. NDA urges them to reconsider the position taken in the Recommended Decision, establish more realistic Class III and Class IV price formulas, and adhere to the required legal principals and historic analysis adopted in prior decisions. NDA further urges that the Recommended Decision be set aside, and considered an investment in learning how end-product pricing works, while a new hearing is called to receive more recent experience with the Class III and IV formulas, and to provide an opportunity for the industry to reconsider and provide additional evidence on end-product pricing and commentary regarding the appropriate methodology and assumptions, in light of the Recommended Decision.

Respectfully Submitted,

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**Table A****Class III at Different Cheese and Butter Prices (Recommended Decision)**

NASS Cheese	Butter						
	1.20	1.30	1.40	1.50	1.60	1.70	1.80
1.00	9.01	9.06	9.10	9.14	9.18	9.23	9.27
1.05	9.50	9.54	9.59	9.63	9.67	9.71	9.76
1.10	9.99	10.03	10.07	10.12	10.16	10.20	10.24
1.15	10.47	10.52	10.56	10.60	10.65	10.69	10.73
1.20	10.96	11.00	11.05	11.09	11.13	11.18	11.22
1.25	11.45	11.49	11.53	11.58	11.62	11.66	11.70
1.30	11.94	11.98	12.02	12.06	12.11	12.15	12.19
1.35	12.42	12.47	12.51	12.55	12.59	12.64	12.68
1.40	12.91	12.95	13.00	13.04	13.08	13.12	13.17
1.45	13.40	13.44	13.48	13.52	13.57	13.61	13.65
1.50	13.88	13.93	13.97	14.01	14.05	14.10	14.14
1.55	14.37	14.41	14.46	14.50	14.54	14.58	14.63
1.60	14.86	14.90	14.94	14.99	15.03	15.07	15.11
1.65	15.34	15.39	15.43	15.47	15.52	15.56	15.60
1.70	15.83	15.87	15.92	15.96	16.00	16.05	16.09
1.75	16.32	16.36	16.40	16.45	16.49	16.53	16.57

Whey 0.23

**Table B****California Class 4b prices (new formulas, January 2002)**

CME Cheese	Butter						
	1.20	1.30	1.40	1.50	1.60	1.70	1.80
1.00	8.17	8.18	8.19	8.20	8.22	8.23	8.24
1.05	8.66	8.67	8.69	8.70	8.71	8.72	8.74
1.10	9.16	9.17	9.18	9.19	9.21	9.22	9.23
1.15	9.65	9.66	9.68	9.69	9.70	9.72	9.73
1.20	10.15	10.16	10.17	10.19	10.20	10.21	10.22
1.25	10.64	10.66	10.67	10.68	10.69	10.71	10.72
1.30	11.14	11.15	11.16	11.18	11.19	11.20	11.21
1.35	11.63	11.65	11.66	11.67	11.68	11.70	11.71
1.40	12.13	12.14	12.15	12.17	12.18	12.19	12.21
1.45	12.62	12.64	12.65	12.66	12.68	12.69	12.70
1.50	13.12	13.13	13.15	13.16	13.17	13.18	13.20
1.55	13.62	13.63	13.64	13.65	13.67	13.68	13.69
1.60	14.11	14.12	14.14	14.15	14.16	14.17	14.19
1.65	14.61	14.62	14.63	14.64	14.66	14.67	14.68
1.70	15.10	15.11	15.13	15.14	15.15	15.17	15.18
1.75	15.60	15.61	15.62	15.64	15.65	15.66	15.67

**Table C****Per Cwt. Price Differences (FO Class III - CA Class 4b)**

Cheese	Butter						
	1.20	1.30	1.40	1.50	1.60	1.70	1.80
1.00	0.85	0.88	0.91	0.94	0.97	1.00	1.03
1.05	0.84	0.87	0.90	0.93	0.96	0.99	1.02
1.10	0.83	0.86	0.89	0.92	0.95	0.98	1.01
1.15	0.82	0.85	0.88	0.91	0.94	0.97	1.00
1.20	0.81	0.84	0.87	0.90	0.93	0.96	0.99
1.25	0.81	0.84	0.87	0.90	0.93	0.96	0.99
1.30	0.80	0.83	0.86	0.89	0.92	0.95	0.98
1.35	0.79	0.82	0.85	0.88	0.91	0.94	0.97
1.40	0.78	0.81	0.84	0.87	0.90	0.93	0.96
1.45	0.77	0.80	0.83	0.86	0.89	0.92	0.95
1.50	0.76	0.79	0.82	0.85	0.88	0.91	0.94
1.55	0.76	0.79	0.82	0.85	0.88	0.91	0.93
1.60	0.75	0.78	0.81	0.84	0.87	0.90	0.93
1.65	0.74	0.77	0.80	0.83	0.86	0.89	0.92
1.70	0.73	0.76	0.79	0.82	0.85	0.88	0.91
1.75	0.72	0.75	0.78	0.81	0.84	0.87	0.90